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DIRECTORATE OF
INTELLIGENCE

Intelligence Memorandum

INTERNATIONAL FINANCE SERIES, NO. 3

The World Gold Market

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Foreword

This memorandum, the third in a series,* discusses some of the growing pains of the new, two-tier gold market system. Based on information available through 30 June 1968, it covers developments in the official and private sectors of the world gold market, as well as the emergent role of South Africa in the system. Subsequent monthly issues will up-date analysis presented here and will focus on world gold market problems either omitted or only cursorily examined in this issue.

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CENTRAL INTELLIGENCE AGENCY
Directorate of Intelligence
11 July 1968

INTELLIGENCE MEMORANDUM

The World Gold Market

Summary

The devaluation of the British pound in November 1967 precipitated a gold crisis that lasted four months, until the Washington agreement among the Gold Pool members on 18 March 1968, which established a two-tiered system for gold transactions. Under the new system, payments between central banks may be settled at $35 per ounce, while private trading takes place at free market prices governed by supply and demand. To keep the official and private markets separated, leading Free World central banks have pledged not to sell and, at least for the time being, not to buy gold in the free market.

Two major developments have characterized the free market since mid-March: (1) the absence of South African gold sales, and (2) a sharp decline from crisis levels in the demand for gold. Lack of South African gold sales has tended to raise gold prices, while the presence of a large "overhang" of gold, bought during the crisis, has tended to depress prices. As of 30 June, gold prices had not risen sufficiently to cause substantial sales out of the estimated $2.3 billion overhang. Some of the large holders of the overhang are financially capable of withholding their gold from the market for a considerable period. However, a significant fraction of the overhang probably is still held by small speculators who cannot afford to hold out very long, even though such people

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have probably been selling small amounts continuously since April. In the absence of any new crisis, these sales plus those from producers other than South Africa will probably prevent any substantial rise in free market gold prices for the remainder of 1968.

The Washington agreement ended the major run on the US gold stock but does not isolate it from sales to central banks. As of 26 June, 15 central banks had purchased a total of $325 million and intend to purchase about $160 million to $170 million more. However, these sales are partly offset by US purchases of gold from France, which will total $370 million by the end of July 1968.

As of 1 July, there have been only five gold transactions by central banks that could conceivably be considered violations of the intent of the Washington agreement. These transactions involved the central banks of South Africa, Portugal, Peru, Libya, Kuwait, and possibly France.

The London market reopened 1 April without its two major sources of supply -- South Africa and the London Gold Pool. The Swiss gold market centered in Zurich now has a chance of becoming the dominant world gold market, although the London market still has the advantage of being able to acquire South African gold at the lowest shipping costs. Three of Switzerland's largest commercial banks are trying to establish Zurich as the dominant world gold market. Control over the free market price is important for these banks because they have substantial gold holdings and large loans against gold collateral and use gold as part of their liquidity requirement. These banks probably have bought and sold gold on their own account to influence the market.

Since mid-March, South African gold has been the object of competition between the Swiss banks and a group headed by Engelhard Industries -- a major US industrial user of gold. South Africa has obtained the best possible offers from the Swiss banks and the Engelhard group -- the principal participants in the free market. South Africa now wishes to reach an agreement with the official side of the two-tier market and is probably prepared to compromise to do so, even though it could continue withholding its gold for months without detrimental economic effects. In recent weeks the two-tiered gold market has seemed more durable and the prospects for an increase in the official price of gold more remote. South Africa, therefore, is increasingly inclined to accommodate itself to the two-tiered system. Its preference would probably be for a stable relationship, even though this entailed a lower average price for its gold, rather than a higher price involving an unstable market.

Introduction

1. Prior to mid-March 1968, world gold markets functioned under a relatively stable regime, with London and Zurich the chief trading centers. Zurich was a "retail" center, the point at which demand from private persons and other marketing centers throughout the world was mainly concentrated. London, in contrast, was a "wholesale" center and the predominant source of supply for Zurich. The chief reason for this division of the world gold market was London's unequalled access to sources of supply. South Africa, the Free World's major gold producer, marketed all its newly mined gold in London through the agency of the Bank of England. The Bank of England also acted as agent for the London Gold Pool, an informal association of eight central banks established in 1961 to manage sales and purchases of gold for the monetary stocks of the chief Free World financial powers in support of the official gold price of $35 per ounce.*

2. After British devaluation of the pound in November 1967, the stability of this market system suffered a serious breakdown. A series of international financial crises in subsequent months caused a vast "run" on official gold stocks, which the Gold Pool members remained prepared to sell at the fixed price of $35 per ounce. By mid-March 1968 the Pool had lost $2.8 billion in monetary gold reserves (see Table 1).

3. After an emergency weekend meeting of the Gold Pool members, this rapidly deteriorating market mechanism was fundamentally altered by the members' Washington Communique of 17 March 1968. The Communique abolished the gold pool, cut off private markets from access to monetary gold stocks, and established a two-tiered system for gold transactions. As before, balances of payments could be settled with transfers of official monetary gold valued at $35 per ounce. Private gold trading, however, would take place at free market prices determined by supply and demand. The

* *The eight Gold Pool members were the United States, the United Kingdom, France, West Germany, Italy, the Netherlands, Belgium-Luxembourg, and Switzerland. France withdrew its support for the Pool in June 1967.*

Table 1

Total Gold Losses to the Gold Pool
During the Gold Crisis
20 November 1967 - 15 March 1968

Million US $

Period	Amount	Cumulative
1967		
20 Nov - 24 Nov	519	519
27 Nov - 1 Dec	157	676
4 Dec - 8 Dec	14 (net gain)	662
11 Dec - 15 Dec	535	1,197
18 Dec - 22 Dec	59	1,256
27 Dec - 29 Dec	61	1,317
1968		
Jan (Total)	100	1,417
1 Feb - 28 Feb	95	1,512
29 Feb	15	1,527
1 Mar	90	1,617
4 Mar	55	1,672
5 Mar	56	1,728
6 Mar	47	1,775
7 Mar	55	1,830
8 Mar	182	2,012
11 Mar	118	2,130
12 Mar	103	2,233
13 Mar	179	2,412
14 Mar	389	2,801
15 Mar	London closed	
Total		*2,801*

Communique pledged the signatories not to effect sales to the free market and implied that they would refrain from making free market purchases, including purchases of newly mined gold.

4. Two main developments have characterized the free gold markets since the new system was established: (1) the withholding of South African gold from the market, and (2) a sharp decline in

market demand for gold from its crisis level prior to 15 March. While the absence of South African gold sales has deprived the market of a major source of regular supply, thus tending to raise the gold price, the absence of strong demand -- as well as a large "overhang" of gold supplies bought during the November-March crises for speculative purposes -- has tended to depress the market price. With the volume of trading in the principal markets dropping off to "normal" levels of only a few tons per day, free market prices floated upward only very sluggishly, reaching a peak of about $42.60 per ounce during the fourth week in May, then falling slightly during the rest of May and June to average levels of slightly more than $41.00 per ounce. Whereas the massive gold purchases of the crisis period had been made largely in anticipation of a steep increase in the price of gold (a doubling or more), such an increase has not thus far materialized under the new system (see Table 2).

Size and Significance of the "Overhang"

5. The world's enormous private gold hoards were augmented during the November-March crises by the $2.8 billion which was drained out of official monetary gold stocks through the London Gold Pool. Because these additions to hoards were purchased largely for speculative reasons, they are a highly volatile part of the free market. A substantial increase in free market gold prices could stimulate large sales of gold from this "overhang," thus dampening or reversing the upward price trend until the gold involved found its way into the hands of more permanent holders. A substantial decrease in the free market gold price could also stimulate massive sales from the "overhang" as gold holders made efforts to cut their losses. This would further depress market prices. The latter eventuality has been a principal worry of the South Africans, who fear that large sales of their newly mined gold would trigger a massive flow of the "overhang" onto the market, causing a serious depression of the price of gold.

6. As of 30 June 1968, gold prices had not risen sufficiently to bring forth substantial sales

Table 2

Price Range in Principal Gold Markets
18 March-21 June 1968

US $ per Fine Ounce

Week	London a/	Zurich b/
18-22 Mar	Closed	36.50 to 39.50
25-29 Mar	Closed	38.50 to 40.00
1- 5 Apr	36.70 to 38.00	37.13 to 38.00
8-12 Apr	37.00 to 38.05	37.00 to 38.00
15-19 Apr	37.65 to 38.10	37.50 to 38.25
22-26 Apr	38.00 to 38.65	38.13 to 38.65
29- 3 May	38.55 to 39.60	38.65 to 39.75
6-10 May	39.30 to 39.80	39.25 to 40.00
13-17 May	39.40 to 41.60	39.38 to 41.25
20-24 May	41.40 to 42.60	41.50 to 42.65
27-31 May	41.50 to 42.00	40.00 to 42.25
3- 7 Jun	41.15 to 41.95	41.18 to 41.75
10-14 Jun	40.20 to 42.10	40.20 to 42.38
17-21 Jun	40.70 to 41.40	40.62 to 41.50

a. Based only on the morning and afternoon fixes.
b. Not exactly comparable to London; consists of the lowest offer to buy and the highest offer to sell during the week.

from the "overhang," which probably still amounts to about $2.3 billion at $35 an ounce. One report states that $800 million of the original $2.8 billion may have been sold off to non-speculative buyers since mid-March, but a rough estimate of about $300 million seems more realistic, given available fragmentary data on market volumes in London and Zurich. To this $300 million may be added roughly $200 million representing industrial gold consumption during the November-March period.

7. Available information supports only crude judgments as to the distribution of the $2.3 billion total. Swiss banks probably hold at least $1.25 billion on their own account. [redacted] 25X1

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25X1 [redacted] This leaves an estimated $750 million
25X1 unaccounted for. However, it leaves many potential gold holders unaccounted for as well -- commercial banks in Europe and elsewhere, private persons, and large corporations, many of which are known to have favored some diversification of assets into gold during the troubled early months of 1968. Given this large, mixed group of potential gold holders, it is reasonable to assume that several hundred million dollars in gold are widely distributed among several hundred small holders, most of whom probably can never be identified.

8. The implication of these estimates is that, while much of the "overhang" is concentrated among large holders who can afford to maintain their stockpiles for a considerable period -- and who probably bought gold in the hope of long-term capital gains -- a substantial amount remains in the hands of small holders, who hold gold for short-term speculative motives and for whom the cost of holding gold is high. Many small holders cannot long afford the costs -- at least 10 percent a year, counting storage and insurance costs as well as forgone interest earnings -- particularly if they have converted substantial proportions of their earning assets into gold in anticipation of a quick and massive increase in the price of gold. Industrial gold consumption, presently the principal demand factor in the free market (around $800 million a year), is being at least partly supplied by sales from such small holdings. With roughly $400 million annually in new supplies entering the world gold market from mines outside South Africa (mainly in the United States and Canada), such small sales probably can supply the market for the remainder of 1968 without any substantial increase in gold prices, provided that no new wave of speculative demand emerges. Renewed speculation could arise from a number of possible causes, including another sterling crisis or the failure of the US balance of payments to improve. But the position of both sterling and the dollar was strengthened considerably.

The "Official" Market for Gold

Gold Transactions Among Central Banks

9. The Washington agreement was a major source of relief to the United States, which had been providing 60 percent of the gold sold by the London Gold Pool. However, the US gold stock is not entirely protected from depletion by the agreement. As long as foreign central banks comply with the agreement and do not participate in the private market, they may purchase gold from the United States.

10. Fifteen central banks have already purchased a total of $325 million in gold from the United States (see Table 3). Three others plan soon to purchase a total of $156 million to $168 million. In mid-May the Bank of France indicated that it would purchase about $90 million over a three-month period, but the recent French disorders eliminated these plans before any purchases could be made. In fact, France recently sold $220 million in gold to the United States as part of a $400 million sale to a number of Western central banks, and intends to sell another $300 million during July, of which the United States will receive $150 million. Most of the purchases of US gold reflect the desire of small central banks, still uncertain about international monetary prospects, to diversify their reserve holdings and purchase gold as a precaution against a possible devaluation of the dollar or sterling.

11. As of 1 July, there appear to have been only five gold transactions by central banks that conceivably could be interpreted as possible violations of the intent of the Washington agreement. One case involves a purchase of South African gold, and four concern central bank dealings in private gold markets.

Case One

12. So far there has been only one case where the Reserve Bank of South Africa (which buys all newly mined gold in the country) has offered to sell gold to another central bank. During the latter part of June the Reserve Bank is understood

Table 3

Actual and Planned Country Transactions in Gold with the United States
1968

Million US $

Purchases from the United States (1 April-26 June)		Gold Sales to the United States (1-20 June)		Planned Purchases from and Sales to the United States (26 June - End of Year)	
Country	Amount	Country	Amount	Country	Amount
Argentina	5.0	France	220.0	Purchases	
Belgium	32.5	Netherlands	30.0		
Cyprus	21.0	United		Argentina	20.0
Ireland	34.3	Kingdom	50.0	Kuwait	36.0 to 48.0
Iraq	28.0			Portugal	100
Italy	25.0				
Jordan	7.5			Sales	
Lebanon	21.0				
Malaysia	37.7			France	150
Nepal	6.0				
Nigeria	9.3				
Saudi Arabia	50.0				
Singapore	10.0				
Switzerland	25.0				
Turkey	12.7				
Subtotal	325.0				
IMF a/	5.1				
Total	*330.1*		*300.0*		*6 to 18 b/*

a. Excluding transfers of earmarked gold to the IMF.
b. Net purchases.

to have offered to sell the Bank of Portugal $34 million in gold, with payment in sterling and delivery to the Bank of England early in July. The sale has been confirmed.

13. Governor Barbosa of the Portuguese Central Bank and Minister of Finance Cortes affirmed their support of the Washington agreement to US officials in Lisbon on 18 March. On 19 March, Vice Governor Nunes told US officials in Lisbon that the Bank of Portugal had always purchased gold through central bank arrangements and the Bank intended to continue that policy. Therefore, Bank of Portugal officials may view the purchase from South Africa as a legitimate purchase of gold from another central bank, no different from the purchase of $100 million they plan to make from the United States, and not a violation of the Washington agreement. The Bank of Portugal may consider the approximately $600 million in gold held by the Reserve Bank at the time of the Washington agreement as gold available for sale at the official price of $35 per ounce. The Portuguese decision to accept the South African offer may have been influenced by the close political and economic ties existing among the Portuguese, Rhodesians, and South Africans in southern Africa.

Case Two

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[redacted] Two days after the Washington agreement the Peruvian central bank had stated that it would continue its policy of non-participation in the market for domestically produced gold. At the same time it was noted by US officials in Lima that the central bank is authorized to conduct transactions in gold with local commercial banks.

Case Three

15. The Bank of Libya purchased about $1 million in gold from the Union Bank of Switzerland in mid-May. According to the Deputy Governor of the Bank of Libya, however, it is the commercial department of the Bank of Libya that purchases and sells gold.

This department is entirely separate from the central banking department of the Bank of Libya and is subject to the same regulations as any other Libyan commercial bank.

Case Four

16. Kuwait, in addition to its plan to purchase $36 million to $48 million in gold from the United States, has purchased gold in the free market.

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17. These purchases represent part of Kuwait's diversification of foreign reserves from sterling into gold, other currencies, Eurobonds, and other securities. The gold purchases from the private market were by members of the Sabah family, although there is a very vague distinction between the Sabah family and the "government" of Kuwait (family members are also government officials).

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<u>The Free Markets for Gold</u>

<u>The "New" London Market</u>

19. The London gold market reopened on Monday, 1 April after being closed for two weeks.* Although

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* *The five gold merchants who "make" the London market are: Johnson, Matthey & Co., Ltd.; Mocatta & Goldsmid, Ltd.;* [footnote continued on p. 14]

many of the basic techniques of the London gold trade are long established, several changes were made in the operating rules while the market was closed. First, authorized bullion dealers and banks cannot enter into future sales without the permission of the Bank of England. By making all transactions current or "spot" only, the Bank of England intends to limit speculation. Second, the Bank also ruled that commercial banks may not finance the purchase of gold for non-residents by lending foreign currency or accept gold as collateral for foreign currency advances to non-residents. Third, two price fixings are made, one at 10:30 a.m. and the other at 3:00 p.m. (prior to closure, only the morning price fix was made). This change is intended to allow an afternoon adjustment to the morning's market. The price fix in the afternoon is used in New York by the Engelhard Co. as the basis of setting the daily gold quotation in the United States.* Finally, London gold dealers hoped to encourage selling through the London market by eliminating the commission charged to sellers (formerly 12½ cents on each $1,000 in gold traded) and increasing the charge to buyers (from 12½ cents to $2.50 per $1,000).

20. The basic problem facing the London market is the absence of its two largest suppliers -- South Africa and the Gold Pool. The Bank of England's fourteen-year partnership with the Reserve Bank of South Africa had originally established London as the dominant world gold market. London

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Samuel Montague & Co., Ltd.; N.M. Rothschild & Sons; and Sharps, Pixley & Co. Montague and Rothschild are merchant banks; Mocatta is wholly owned by a merchant bank; Sharps, Pixley is solely a broker; and Johnson, Matthey is a metallurgical company. Johnson, Matthey and Rothschild melt, refine, assay, and process gold. Rothschild's banking house is the location of the two daily price fixings which take place under the chairmanship of the Rothschild representative.

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* [redacted] *gold is normally purchased below the Engelhard quote and that Engelhard uses the price as only a rough basis for setting the price to his customers.*

is still an important market because of its experience and banking and storage facilities, but now must share its role as a leading market with Zurich.

21. London retains an important potential advantage over other European markets in the handling of South African gold. The unique shipping arrangement between the Reserve Bank and the UK's Union Castle Steamship Line makes delivery to London easily the cheapest possible manner of moving gold from South Africa to Europe. Whether this advantage will result in London's regaining its former preeminence, however, is highly questionable.

22. The weekly ranges of prices on the London market are shown in Table 2. There is no reliable estimate of the volume of trading on the London market, because the figures are not made public. In addition, volume would be difficult to estimate, as London dealers match as many buy and sell orders as possible and enter the market actively only to transact the net balance of purchases or sales.

The Zurich Market

23. Whereas London traditionally was the "wholesaler," Zurich was the "retailer" of gold, depending on London for its supplies. In 1960 and 1961 the South African Reserve Bank tried selling some of its gold through the Zurich market, but the cost of shipping by air was prohibitive and the Reserve Bank shortly returned to selling in London.

24. Now, however, Zurich rivals London for leadership among the world's gold markets and is making a strong bid to attract South African gold sales when these are resumed. The three largest Swiss commercial banks -- the Swiss Bank Corporation, the Swiss Credit Bank, and the Union Bank of Switzerland -- are cooperating to persuade the South Africans to market from 20 to 50 percent of their annual output of gold in Zurich. The "Big Three" would act as the selling agent for the South African Reserve Bank, as the Bank of England did from 1954 to mid-March 1968.

25. In preparation for assuming the role of the major international gold market, the Swiss banks

have speeded up their deliveries. For example, 25X1 [redacted] the Zurich gold market can deliver gold to Milan overnight at shipping rates below those charged by the London dealers. In addition, each of the "Big Three" has now acquired control of sizable gold refineries. The Swiss Credit Bank, until recently the only one of the "Big Three" without a refinery, acquired Valcambi S.A., after fierce competition with the Union Bank of Switzerland. The Union Bank was seeking additional refining capacity to augment its own overloaded refinery, Argot S.A.

26. There is more than prestige involved in the Swiss bank efforts to establish Zurich as the major world gold market. Because of their large gold holdings, the Swiss banks have a very important stake in being able to influence the free market price. The "Big Three" alone are reported to hold a total of about $350 million in gold. Total gold holdings by all commercial Swiss banks are reported to total over $1¼ billion. In addition, Swiss banks are reported to have very large outstanding loans against gold collateral, at $35 per ounce, and are afraid that if gold prices fall below this level borrowers will choose to surrender collateral rather than repay the loans. The banks have ceased making loans for gold purchases on margin and have begun calling in all outstanding margin loans. Another problem and source of concern arises from the Swiss banks' traditional use of large gold stocks as a partial fulfillment of their primary liquidity reserve requirement, while using Swiss francs, National Bank deposits, and postal notes for daily transactions. With gold no longer guaranteed a "floor" price of $35 per ounce, the basic liquidity of the Swiss banking system is subject to contraction if the free market price ever falls below $35.

27. Because the Swiss banks have an important stake in a high, stable free market price for gold, they are trying to regulate the Zurich gold market and have probably undertaken price support operations. The three major banks have contributed a total of 15 tons of gold to use in their combined daily trading efforts and have agreed to exchange information and to consult jointly on the price of any transaction involving more than 100 kilograms of gold. Actual cooperation probably is limited, however, for these three banks traditionally have been intense competitors.

28. Prices on the Zurich market are shown in Table 2. No reliable estimates are available for the daily volume of business conducted in the Zurich market, because the Swiss banks have ceased to publish accurate figures. [redacted] the daily volume figures occasionally leaked are highly inflated to give the impression that Zurich is a larger market than it actually is. The average daily volume on the Zurich market is estimated roughly to be 3 to 5 tons, with an occasional "heavy day" of 6 to 7 tons.

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South Africa's Role in the Two-Tier Market

29. South Africa, which accounts for three-fourths of the Free World output of gold, is in a pivotal position between the two segments of the two-tier gold market. It could choose to sell all its annual output on the free market. These sales, in excess of $1 billion annually, would have a strong depressing effect on the free market price under present demand conditions, and South Africa's revenue from gold sales would no longer be guaranteed because the free market price fluctuates. Alternatively, South Africa could attempt to persuade central banks to resume purchases of South Africa's annual gold output at $35 per ounce. This would again assure South Africa of stability in its major source of income. However, South African appeals would have to overcome opposition from the signatories to the Washington Communique. South Africa could continue to withhold its gold from both markets at least through the end of 1968 without detrimental effects on its economy, but will have to sell its gold output sooner or later.

30. Eventually, the most likely South African move will be an attempt to market gold through both tiers of the two-tier market. South Africa has already accomplished part of this task by maneuvering the two principal consortia in the private market into a joint offer that is in the best interest of South Africa. The official side of the market has proved more obstinate to South African overtures, and any marketing arrangements will most likely require concessions from South Africa. However, since all current information suggests that South Africa wishes to be an accepted participant in both tiers of the two-tier market, the South

African government is probably prepared to compromise. The following discussion covers the competition for South African gold within the private segment of the two-tier market and South African approaches to the official segment of the market. It concludes with a judgment concerning South Africa's most probable policy position at present.

Competition for South African Gold*

31. Three of Switzerland's largest commercial banks -- the Swiss Bank Corporation, the Swiss Credit Bank, and the Union Bank of Switzerland -- have joined to persuade the South African government to sell some of its gold in Switzerland. The Swiss "Big Three" would act as agents for the Reserve Bank of South Africa as the Bank of England did prior to the mid-March closing of the London market.

32. Although the three Swiss banks are partners, personnel of the union Bank of Switzerland have conducted most of the negotiations in South Africa; most of their efforts were focused on the Reserve Bank of South Africa and the South African government. The Swiss Bank Corporation was considerably less involved than the Union Bank and at no time did the Swiss Credit Bank participate. The Union Bank acquired information through and focused much of its effort on Union Acceptances, Ltd., Johannesburg, a financial house with extensive contacts in the South African Reserve Bank.

33. Evidence of an organized group in competition with the Swiss banks first appeared in mid-March. The group consists of Banque De L'Indochine, the Dreyfus Bank, CLA (a French bank), Samuel Montague (a London gold dealer), and Engelhard Industries which is in charge of the effort. The other three members have not been disclosed. The Engelhard group hopes to persuade the South Africans

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(specifically, the Chamber of Mines*) to allow the group to act as selling agent for all of South Africa's gold production. Such an arrangement would give the Engelhard group nearly a world monopoly over the distribution of gold for industrial uses. The number of contacts available to the Engelhard group is much greater than that available to the Swiss banks. However, both have Union Acceptances as contact -- an arrangement that possibly explains why many of the Swiss bank moves were known to the Engelhard group and why a secret bid of the latter was known to the Swiss banks.

34. The main strategy of the Engelhard group was to convince South Africa that the group controlled all of the major outlets to industrial users of gold in Europe and in the United States. In fact, all of these outlets are not now under the control of the group but would be once South Africa accepted the group's offer. The Swiss banks were to be completely excluded. Indirect support for the Engelhard group was expected from the Anglo-American Corporation of South Africa, whose mines account for about 40 percent of all of South Africa's gold production.

35. Since the Engelhard group had focused its selling effort on the Chamber of Mines while the Swiss banks had focused theirs on the Reserve Bank and the South African government, any difference of opinion between the Chamber and the government, and which of these would make the final decision on gold sales, were questions of paramount importance to both sides. It is clear, however, that any important differences between the Chamber and the South African government were largely in the minds of the competitors. Considerable consultation and cooperation

* *The South African gold mining industry is composed of more than 60 mining companies which are owned or controlled by seven major financial houses. Coordination of mining activities is done through the South African Chamber of Mines. The Chamber represents the industry in negotiating agreements with government departments and also authorizes the sale of gold to the Reserve Bank of South Africa. In effect, the Chamber controls only the timing of sales as, by law, they are prohibited from selling gold except to the Reserve Bank.*

between the government and the Chamber would have been necessary for the deft manipulation of the competitors that the South Africans have thus far employed. Neither the Swiss nor the Engelhard group was very difficult to manipulate. Over-optimism could be generated very quickly in either one by simply asking for a bid or occasionally making an encouraging statement. South Africa does both repeatedly.

36. By the end of May the Engelhard group realized that its original strategy of excluding the Swiss banks and establishing a near monopoly of the world distribution of gold was no longer tenable. The Swiss had a competitive edge as a result of their willingness to advance South Africa large sums in foreign exchange, accepting the gold being withheld from the market by South Africa as collateral. [redacted] 25X1 The Engelhard group probably is now willing to enter an arrangement that would include the Swiss, if the South Africans made such an offer.

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South Africa Approaches the IMF

41. It was announced on Friday, 21 June that South Africa had approached the International Monetary Fund (IMF) with an offer to sell about $35 million in gold to the IMF. The South Africans claimed that the IMF according to its own rules is obligated to purchase gold from South Africa at the official price of $35 per ounce. While many of the Executive Directors were known to be in favor of the purchase, the US government was opposed. Despite opposition the United States had sufficient support to have the issue postponed without forcing it to a vote.

42. On Saturday, 22 June the Monetary Commission of the EEC was the forum for an intra-EEC discussion of the South African claim. The members equivocated by concluding that the IMF should accept the offer of $35 million but deny that it has an obligation to purchase South African gold in the future.

43. Also during the third week of June, there was another transaction involving the IMF indirectly with South South African gold sales. As part of their recent drawings on the IMF, both France and the United Kingdom received a total of $42 million in Rand, the South African currency. South Africa, in turn, in order to avoid a further depletion of its limited foreign currency reserves, bought back its own currency in exchange for gold from France and the United Kingdom.

The Two-Tier Market and South African Policy Options

44. South Africa has now obtained probably the best possible offer from the private side of the two-tier gold market. While all major participants in the free market probably have approached South Africa with offers, the two principal participants -- the Swiss banks and the Engelhard group -- are South Africa's most likely choices as agents for gold

sales to the free market. The offers from the Swiss banks and the Engelhard group taken together would assure South Africa of: (1) outlets into most of the worldwide industrial market for gold through Engelhard; (2) access to speculative and hoarding demand through the Swiss gold market centered in Zurich; and (3) an available line of credit from the Swiss (with gold as collateral) if South Africa chooses to continue withholding some gold from the market.

45. Although the South Africans continue to encourage the Swiss banks and the Engelhard group, they have not yet accepted these anxiously extended offers. South Africa probably will not accept the offers until some agreement has been reached with the official side of the two-tier gold market -- that is, the United States and the major European central banks -- or until it is convinced that no such agreement is possible.

46. South Africa's first round of contacts with the official side of the two-tier market, through the IMF and several central bankers, has been generally unproductive. The next South African move will be difficult to predict, but several factors will influence it. During June the South African government probably revised its estimate of the endurance of the two-tier market for gold. Initially, the government withheld gold from the market both because of the overhang and to see whether the new two-tier system would last. The arrangement survived and, at present, the chances for its continued viability are improving. South Africa's refusal to sell gold has pushed up free market prices but has not resulted in a breakdown of the two-tier market. Hence, the South African government now probably considers the chances of an increase in the official price of gold to be slight for the foreseeable future. Since South Africa cannot stay out of the market for more than a year or so, it may be ready to decide on an appropriate policy. In fact, for the past several weeks the South African press has urged the government to approach the United States directly on the question of official purchases of South African gold. These factors plus the current inability of the free market to absorb all of South Africa's gold, the availability of Swiss credit, and the recent South African drawing on the IMF suggest that South Africa is prepared to continue withholding gold from the free market in anticipation

of an arrangement with the United States and the major European central banks.

47. South Africa would undoubtedly prefer a substantial revaluation of gold (to perhaps a minimum of $70 per ounce) in terms of major world currencies and the continued use of gold as a major means of payment in international trade and finance. Since the mid-March agreement in Washington, officials of the Chamber of Mines, the Reserve Bank, and the South African government have all made repeated public statements to this effect. But South Africa probably would be willing to settle for much less.

48. An offer which probably would prove acceptable to South Africa would be an agreement requiring central banks or other official monetary authorities (for example, the IMF) to purchase a certain amount of South African gold each year at $35 per ounce.* In turn, South Africa would sell the rest of its output on the free market, probably through the Swiss banks and the Engelhard group. This would give South Africa reliable access to the three major sources of demand for gold -- central banks, speculators and hoarders, and industrial users -- at an average price higher than the official $35 per ounce. It would also enable South Africa, by virtue of its agreement with central banks, to participate in any future decisions on the monetary use of gold, a participation that South Africa would welcome. Moreover, splitting gold sales between the official and private market frees South Africa from sole dependence on uncertain free market prices. In effect, sales to official buyers would always provide a partial floor for the price of South Africa's gold. The stability of such an arrangement would extend in turn to South Africa's own balance of payments and largely eliminate the need for sudden curbs on imports if earnings fell from gold sales abroad.

* *Such an arrangement could be made at least nominally consistent with the Washington Communique by an agreement to classify some portion of South Africa's newly mined gold, by fiat, as "monetary" and therefore eligible for sale to other central banks.*